

FY 2003 BUDGET AND PERFORMANCE REQUIREMENTS

Implementing Activity Based Costing (ABC)

Introduction

CMS has made it a priority to establish a strong link in its budget requests between program outcomes and contractor administrative funding levels. We have made this a priority in order to emphasize the inherent relationship between the two factors: that when administrative funding is reduced (i.e., for contractor operations), the Medicare program suffers.

The current contractor budget categories in CMS's national submissions are aggregations of a large number of functions grouped under broad and equally large dollar amounts. For example, our budget submissions can include a request for \$600 to \$700 million under the general heading "Bills/Claims Payment." As a result of this composite view of contractor operations, the internal and external reviewers of our budget have a less than optimal comprehension of the true impacts of funding variations. In order to identify and underscore the linkage between contractor operations, funding, and program outcomes, we wish to disaggregate the national budget categories into more discrete and meaningful activities. By doing so, we will also be able to focus on and refine (where necessary) select CAFM II-based budget/cost definitions to ensure better uniformity in contractor reporting.

The ABC Workgroup, a group comprised of CMS regional and central office staff from throughout the agency, has focused on 6 Medicare functions. These include bills/claims payment, appeals, inquiries (beneficiaries and providers), provider education and training (PM & MIP), provider enrollment, and medical review. One of the workgroup's primary tasks was to apply the tenets of ABC to these 6 functions in order to develop activity dictionaries for each of them. The dictionaries are included in this BPRs package and should be used by the Medicare contractors to prepare their FY 2003 Budget Requests and in all forthcoming cost reports (i.e., IERs and FACPs).

What is ABC?

In the book, "Activity Based Cost Management, Making It Work," author Gary Cokins states that traditional accounting cost centers (i.e., wages, fringe benefits, supplies, etc.) prevent managers from seeing,

understanding, and reacting to costs that they should be managing. Often times, traditional cost accounting hides the actual cost of a product or service. To address this shortcoming, activity based accounting uses action words so that managers are able to understand the root causes of costs by identifying their company's "end-to-end" business processes. As such, ABC is a management reporting system that focuses on the costs of the work **activities** associated with operating a business in lieu of the standard **cost centers** (e.g., lump sum salaries and fringe benefits) in the traditional cost accounting structure. An activity is defined as a unit of work usually done by one or more persons belonging to the same office, branch, or other small group. ABC identifies the end-to-end business processes for both people and systems in each activity so that the total costs of the activity are fully visible to program managers. This methodology allows companies to avoid the arbitrary "peanut butter spreading" of indirect costs, introducing a deeper understanding of the company's financial information that can facilitate the introduction of major process improvements.

Specifically, by identifying the **resources** - funding, people, assets - consumed by each **activity** that is performed in a company, the application of ABC allow companies to:

- Apply more precise cost management methodologies;
- Identify the cost driver behind an activity (i.e., the root cause of changes in the amount of resources an activity consumes -- for example, the source of an inquiry may determine the amount of time spent responding to it, so the source becomes a cost driver);
- Convert an "indirect" expense into a "direct" expense by assigning it to an activity;
- Clarify the relationship between activities;
- Eliminate non-value added processes, and;
- Present a true picture of what a discrete activity actually costs.

ABC's cost-finding objective is to identify and trace all *material* costs incurred in making a specific product or providing a service back to the activities that produce that output (*note: a cost item is considered material if it would influence decisions by internal or external customers, suppliers, and other stakeholders*). In their book, "Activity-Based Management in Government," authors Joseph Kehoe, et al cogently illustrate the differences between traditional cost accounting and the "verb-noun" application of ABC in the following chart:

**Traditional versus Activity Views of Cost
in the IRS Cincinnati Service Center-Processing Center**

Traditional Line Items		New Way: Activity based Costing	
Salaries	\$500,000	Prepare Work Plans:	\$30,000
Telecommunications	100,000	Facilities and Personnel Planning	30,000
Enforcement Expenses	50,000	Mail Receipt and Sorting	50,000
Facilities	30,000	Document and Data Preparation	180,000
Travel	20,000	Data Entry	40,000
		Document and Security Control	130,000
		Data Reconciliation	90,000
		Taxpayer file maintenance	110,000
		Refund Requests/Correspondence	40,000
Total	\$700,000	Total	700,000

By implementing ABC into the Medicare contractor budget process, CMS hopes to better understand what its activities, products and services cost, as well as what drives those costs. In doing so, the agency will be better positioned to defend its budget requests and to explain the ramifications of funding shortfalls.

Assigning Medicare Contractor Costs

As previously noted, the ABC Workgroup has developed activity dictionaries to identify and explain each of the activities associated with the 6 select contractor functions that the group reviewed. The dictionaries describe each activity through definitions and associated tasks that serve to assure a commonality of understanding and agreement. These data dictionaries have been widely circulated throughout CMS and the contractor community for comment and revision.

The Medicare contractors should prepare their FY 2003 budget requests and cost reports based on the activities included in these dictionaries. Please note that the "tasks" provided in the dictionaries

are only meant to provide further clarification and are **not** to be individually costed out -- contractors are only to budget for the activity in aggregate. Per current procedures, an Activity Form in CAFM II must be completed for each activity that includes the following cost items: salaries/wages; fringe benefits; EDP equipment; subcontracts; other direct costs; other costs; non-COB credits; overhead; general and administrative (G&A); and fees/profit. We will also be retaining the Cost Classification Report (HCFA-2580) that presents contractor costs in the more traditional accounting structure. The new activity codes have been incorporated into CAFM II for the FY 2003 budget cycle. Several of the new activities also have workload associated with them, and the derivation for these numbers is included in the BPRs narrative for each respective code.

Assigning Direct Labor Costs to an Activity

Since labor expenses constitute about 55% of the national contractor budget, contractors should first focus on this area. Contractors can assign direct labor costs to the activities in several ways. Joseph Kehoe, et al recommend the following four general steps in determining labor costs:

1. Identify the people in the organization units associated with each activity.
2. Determine the salary of each person on the list, along with job category, classification, or job description.
3. Calculate the percent of time that individuals spend doing specific activities over a designated period (usually one year). When you sum these percentages, you will have the number of full-time equivalents (FTEs) engaged in an activity. *For example, 10 people who spend 10 percent of their time on an activity equal one FTE, as do two people who spend half their time on an activity. Ways to determine these percentages include time cards, time studies, and reports; interviews with managers; observation; and surveys.*
4. Multiply time percentages by annual salaries, assign related benefits, and sum the results by activity to derive total direct labor costs.

Assigning Direct Non-Labor Costs to an Activity

Direct expenses such as travel, training, materials, EDP equipment, supplies and outside contracts should be relatively easy to track to a specific activity. Once these costs have been identified by activity, they

should be allocated throughout the Activity Form in CAFM II in accordance with instructions contained in the Fiscal Administration section of the Medicare Intermediary and Carrier Manuals (MIM and MCM).

Assigning Overhead and G & A to an Activity

The full implementation of ABC into the contractor budget process will occur over several years. Overhead and G&A costs can be the most challenging to trace back to a specific activity since traditional accounting in companies (including CMS) tends to apply simple formulas to derive these costs. Due to the significance of the changes to the budget process that are being introduced in FY 2003, contractors should continue to apply the same methodologies currently referenced in Section 1212.9 and Section 4212.9 in Part em - Fiscal Administration in the MIM and MCM, respectively to derive overhead and G&A costs for the new activities. **However, please note that, with regard to the treatment of overpayment costs, the overhead definition will be refined to indicate that *only* the financial accounting and reporting of overpayments are to be included as an overhead cost, and *not* the development and/or recovery of the actual overpayments.** The new policy regarding overpayment costs is comprehensively stated in its own section in the BPRs, and also described in a more limited fashion, in the narratives for several CAFM II activities that pertain to overpayment development and recovery efforts.

The FY 2003 Budget Cycle

The activity dictionaries included in this BPRs package will be validated and adjusted over the next several years, with all changes incorporated into the contractor manuals. At the present time, all contractors should prepare and submit their FY 2003 budgets electronically in CAFM II, using the new activity codes and corresponding dictionaries included in these BPRs. All contractors should also designate an ABC contact within their company as a liaison with CMS for updates and changes to these new processes. This name should be forwarded to the contractor's respective CMS Regional Office who will forward the information to CMS Baltimore by April 19, 2002.